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Contents

WHAT GOES AROUND COMES AROUND: *DERBY ET AL. V. COMMISSIONER*

By Mark Dietrich, CPA/ABV

Established health care valuation principles from the 1990s remain in full force and effect according to Mark Dietrich, CPA/ABV, founder of Mark Dietrich, CPA, PC, and author of the following article. Mark is coeditor and author of several chapters on medical practices and regulatory matters in Business Valuation Resources' The Complete Guide to Healthcare Valuation, *scheduled for publication in the fall of 2008. He is also a member of the editorial advisory board of* CPA Expert. *You can access his blog at* http://cpanet.typepad.com.

The Tax Court case *Derby et al v. Commissioner*[1] is important for a variety of reasons, not the least of which is its instructive value as today's consolidation in the health care industry mirrors that of the early and mid-1990s when the *Derby* case originated. Key factors in the case include those which this author has repeatedly cited in numerous articles over the last 10 years in *CPA Expert*, the *Journal of Accountancy*, and other professional publications. Those factors are as follows:

1. The use of expected posttransaction physician compensation in the discounted cash flow model based on the transaction documents *rather than* the use of some arbitrary compensation figure, such as the median compensation for a given physician specialty
2. Allocating enterprise or invested capital value among working capital, fixed assets, and intangible assets
3. Carefully studying transaction documents to discern the character and extent of any intangibles being transferred or not being transferred
4. The critical import of allocating between personal/professional goodwill and enterprise goodwill when valuing a medical practice for acquisition by a hospital
5. The importance of any noncompete agreement in determining the value of the medical practice, and the import of *Norwalk v. Commissioner*
6. The need for "donative intent" when claiming a deduction for the value of a medical practice, or other enterprise allegedly donated to a tax-exempt entity
7. The relevance of the Friendly Hills private letter ruling and the 1994 *Exempt Organizations Continuing Professional Education Technical Instruction Program Manual*
8. The citation of the Anti-Kickback Statute (AKS)
9. The issue of the timeliness of the valuation versus the date of the transaction

The *Derby* ruling highlights the typical issues in the valuation of a physician

1 *Charles A. and Marian L. Derby, et al., 1 Petitioners Commissioner,* Respondent, T.C. Memo. 2008-45, Judge Gale

practice for sale or other transfer to a hospital or integrated delivery system. As such, Judge Gale's words are frequently quoted and set off.

CASE SUMMARY

The case arose out of a claimed charitable deduction for the intangible value of the medical practices of more than a dozen physicians who sold their practices to Sutter Medical Foundation (Sutter) in 1994. The purchase agreements contained payments for fixed assets, while the selling physicians retained their accounts receivable.

The transaction took place during the period of consolidation of the health care industry that was associated with the rise of managed care and capitation on the West Coast in the early 1990s and which later spread across the country. Although restrictive managed care and capitation have fallen into disfavor and have lost market share over the last six or seven years, consolidation is once again the rage in health care. And although some markets, such as Boston, are reconsidering the use of capitation, much of the present consolidation is driven by the more typical revenue concerns associated with fee for service medicine. Major hospital and ancillary testing sources of revenue, such as cardiology, orthopedics, and high tech imaging, are driving many of today's transactions.

The key decisions for the court were whether, in fact, there had been a *donative* transfer of intangible value, what the value was, and, *if* the claimed value of the donation was overstated, whether the donor-physicians were subject to understatement or overvaluation penalties. As such, the court carefully scrutinized the valuations submitted by the taxpayers in connection with the donation received.

Critical to the ultimate resolution of the donation issue was a review of the history of the transaction with Sutter, which had declined to *pay* anything for intangible value, citing the AKS, which is the Medicare and Medicaid Patient Protection Act of 1987, as amended, 42 U.S.C. §1320a-7b. The AKS provides for criminal penalties for certain acts that affect Medicare and state health care (for example, Medicaid) reimbursable services. Sutter also cited the "famous" Thornton Letter in which the then Deputy Counsel of the Office of the Inspector General stated that a sale of goodwill by a physician to a hospital was problematic. Peter Grant, legal counsel in the seminal integrated delivery system transaction of the 1990s, represented the *Derby* physicians, known as the Davis Medical Group (DMG).

> Unlike Foundation, Sutter Health was unwilling to pay anything for the intangible assets, or goodwill, that might be associated with petitioners' medical practices.... First, and principally, because Sutter Health's management believed that doing so might constitute a crime under the Medicare and Medicaid antikickback statute, 42 U.S.C. sec. 1320a-7b(b), prohibiting payments for referrals of patients eligible for Medicare or Medicaid; and second, because Sutter Health's management believed, on the basis of their projections of the financial performance of the UHMG [University Health Management Group] physicians' group after acquisition, that any additional payment for intangibles would have rendered the deal financially nonviable for Sutter Health.
>
> Mr. Grant recommended that petitioners structure the transfers of the intangibles as donations because that technique had been used in connection with an acquisition of a group medical practice by a nonprofit medical foundation (*Friendly Hills Healthcare Foundation*), for which Mr. Grant had served as an adviser. Mr. Grant was familiar with the annual *Exempt Organizations Continuing Professional Education Technical Instruction Program manuals*, including the manual for 1994...[emphasis added].

TRANSACTION OVERVIEW

The parties retained Houlihan Lokey (Houlihan), the valuation firm in the Friendly Hills transaction, which arranged for an appraisal of the "business enterprise value" defined in the following text. Note the emphasized items.

> [T]he fair market value of the aggregate assets of [the Davis Medical Group] *exclusive of any*

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benefit or element of value conferred upon Sutter [Health] as a consequence of its current or proposed relationship with * * * [Davis Medical Group][2], and *with consideration of proposed post-transaction compensation and benefits to the physician group.*

Houlihan also agreed to "allocate the appraised value … to each of its physician/shareholders" using a method to be agreed upon in consultation with the [physician] steering committee, but the agreed-upon method "[had to] be acceptable" to Houlihan.

Sutter West Medical Group (SWMG) entered into a professional services agreement (PSA) or employment contract with Sutter as part of the transaction.[3] The court spelled out the key economic terms of the PSA, which included a very limited noncompete—the terms of which are critical in this valuation and, for that matter, any such valuation—and a complex revenue sharing formula that included a minimum compensation guaranty. The PSA also contained what amounted to a signing bonus that the court would see as, in part, a payment for goodwill.

> The PSA contained a noncompete provision, under which SWMG and its physician shareholder/employees were prohibited from participating in the ownership, management, operation, or control of any business or person providing health care services within the service area covered by the agreement. However, specifically exempted from this prohibition was any SWMG physician who left the employment of SWMG.... Departing Physician may give written notice to the Departing Physician's patients named in the Departing Physician's patient list furnished to SMF [Sutter Medical Foundation] on or before the... Effective Date..., announcing the Departing Physician's separation from * * * SWMG and his or her new practice location, and offering the patient an opportunity to choose whether his or her patient records should remain with SMF or be transferred to the Departing Physician.
>
> To provide an incentive to SWMG to form and sustain a group, SMF will pay SWMG a Physician Access Bonus.... The Physician Access Bonus was $35,000 for each of SWMG's full-time physicians.

The transaction documents stated that the seller and buyer believed the purchase price was less than the fair market value and that the difference was being donated. Significantly, the document contained a provision requiring that the appraisal be completed within 60 days—designed to avoid a "stale" valuation. Finally, a discounted cashflow model was used. All of the factors outlined in the case closely track the Friendly Hills private letter ruling and the 1994 *Exempt Organizations Continuing Professional Education Technical Instruction Program Manual.*

As previously discussed, the donation was to be allocated among 29 physicians who formed the group practice based on the valuation. In actuality, the donation was allocated using a formula designed by one of the physicians, which attributed "(i) 50 percent of the aggregate value on the basis of each physician's share of gross revenues generated in the year preceding the transfer to SMF; (ii) 25 percent on the basis of each physician's 'years in the community,' with up to a maximum of 5 years being counted; and (iii) 25 percent on the basis of each physician's share of the aggregate fixed assets transferred to SMF by the SWMG physicians." Although the physicians attached a form 8283 to their tax returns, Sutter never reflected the donation in its tax return—despite the transaction documents obligating it to do so.

TAXPAYERS' VALUATION FOR TRIAL

For health care industry appraisers and valuation analysts, the issues surrounding the appraisal submitted for trial are the most important. Perhaps the most significant feature of the appraisal prepared for the trial was the use of median compensation for the physician-sellers rather than the actual compensation negotiated in the transaction! This remains an item of ill-considered debate and frequently results in mistaken assumptions in physician practice and other professional practice valuation, despite being long-settled and in direct conflict with fair market value.[4] The question can be stated as follows: Would the hypothetical buyer pay a price for the practice based on a *lower* compensation than they intended to pay posttransaction, thereby paying twice to the extent of the extra compensation?[5]

> ...the national median for the 'Western Region' for a weighted average of the medical specialties comprising SWMG, or 45.18 percent in determining the physician compensation expense for the discounted cashflow model.[6] *However, the actual compensation negotiated in the transaction 'provided for compensation to SWMG equal to 57.75 percent of fee-for-service revenue, 47 to 53 percent of capitation revenue, and at least 55 percent of risk pool revenue.' [Emphasis added].*

The appraisal of Ernest E. Dutcher, managing member of National

2 Davis Medical Group later changed its name to Sutter West Medical Group (SWMG).
3 This is a standard feature of purchase transactions.
4 See, for example, "Medical Practices: A BV RX," *Journal of Accountancy*, November 2005.
5 Besides the inurement risk under the Internal Revenue Code, this error creates risk under the AKS and Stark laws.

Business Appraisers, contained other significant weaknesses in the view of the court. There was no allocation of any intangible value to the professional goodwill of the physicians,[7] as opposed to enterprise goodwill, which the court differentiated as follows:

> … no allocation of any value to the professional goodwill of the SWMG physicians despite the fact that Mr. Dutcher distinguishes, in the case of the goodwill of a professional practice, between 'practice' goodwill and 'professional' goodwill, the former attributable to characteristics of the practice entity such as patient records, provider contracts, and workforce in place; and the latter attributable to the personal attributes of the individual practitioner, such as charisma, skill, and reputation' and he acknowledge[d] that professional goodwill is not transferable.

Dutcher's testimony that professional goodwill is not transferable would have been one of many fatal blows to the taxpayers' position. The court went on to discuss the lack of noncompete agreements and importantly emphasized the continuing viability of *Norwalk v. Commissioner*,[8] perhaps the seminal case on the ownership and valuation of personal goodwill and noncompetes. A noncompete is the contractual basis for transferring personal or professional goodwill to an employer. The court also observed that the willing buyer would have insisted on "a significant discount" due to the lack of a noncompete!

> There is no adjustment for the fact that the SWMG physicians were not required to execute noncompete agreements. Mr. Dutcher treated each SWMG physician as transferring an allocable share of SWMG's intangibles, including goodwill, which was not treated as diminished in any way by the physicians' not having executed noncompete agreements with respect to SWMG or SMF. However, in *Norwalk v. Commissioner*, T.C. Memo. 1998-279, we found that there is no transferable or salable goodwill where a company's business depends on its employees' personal relationships with clients and the employees have not provided covenants not to compete…We also believe that, under the willing buyer/willing seller standard of fair market value… a willing buyer of SWMG on the transaction date would have insisted on a significant discount with respect to the value of the entity's intangible assets, precisely on account of the absence of noncompete agreements from the SWMG physicians.

Other problems cited by the court included the taxpayers' use of an intangible value allocation model developed by one of the taxpayers rather than one based upon sound appraisal techniques and the taxpayers' failure to include in the valuation any consideration of the $35,000 signing bonus described previously.

THE DONATION

A fundamental requirement in a charitable transfer is that the contributor have "donative intent" in order to receive a tax deduction. Donative intent contemplates a disinterested gift to a charitable organization without the donor receiving any corresponding benefit. It remains commonplace to attempt to structure physician practice transfers as part-sale, part-donation in the current environment.

In its analysis of the transaction, the court found that the taxpayers received significant benefits from the transaction, which belied any intent to make a disinterested donation with no consideration in return. The court cited the advantages of patient retention, negotiating leverage as part of a larger system, and compensation based upon a percentage of net revenue, all of which were embodied in an employment contract with 'carefully delineated terms.'

CONCLUSION

Consolidation trends are cyclical, and the wave that collapsed 10 years ago in the health care industry is back again. *Derby* reminds us that the old adage, "Those who fail to learn from history are doomed to repeat it," remains in full force and effect. From the standpoint of the hypothetical buyer, the court reiterated old guidance with respect to the common sense requirement that the value of the practice be based on expected posttransaction compensation. Equally important, the court restated the principles espoused in the *Norwalk* case that contracts—in this case the purchase and sale and PSA—be part of the analysis of intangible value because of the effect of any noncompete agreements. Thus, when valuing a medical practice for purposes of an actual transaction, the appraiser must be familiar with the terms of that transaction if the buyer and seller are to rely upon it for regulatory purposes. As the court seemed to suggest about the appraisal submitted by the taxpayers in this case, something other than that which the parties transacted was valued. Transactional valuation *requires* understanding the terms of the transaction in order to opine on fair market value.

6 The phrase "national median for the 'Western Region'" appears to be a misnomer. The data were taken from the MGMA Physician Compensation Survey 1994 "Report based on 1993 Data"

7 "Identifying And Measuring Personal Goodwill In A Professional Practice," *CPA Expert*, Spring 2005 and Summer 2005.

8 T.C. Memo. 1998-279; See "Goodwill Requires Enforceable Covenant Not To Compete," *CPA Expert*, Spring, 1999.

THE SELECTION OF MARKET-DERIVED ROYALTY RATES IN THE RELIEF FROM ROYALTY METHOD

By Ashley L. Reilly and Robert F. Reilly, CPA/ABV

In the summer 2008 issue of CPA Expert, *the authors of the following article discussed the analytical strengths and weaknesses of the relief from royalty method of intellectual property valuation. In the following article, they discuss what valuation analysts need to consider in selecting market-derived royalty rates to use in the relief from royalty method.*

There are four types of intellectual property: patents, trademarks, copyrights, and trade secrets. The valuation analyst may be asked to value intellectual property for the following purposes:

1. Transaction pricing and structuring
2. Taxation planning and compliance
3. Financial accounting and fair value reporting
4. Financing securitization and collateralization
5. Corporate governance and commercialization planning
6. Litigation support and expert testimony

Valuation analysts often think first of using income approach valuation methods to value intellectual property. These methods quantify various measures of economic income related to the intellectual property, including residual or excess income, differential or incremental income, profit-split income, residual profit-split income, and others. Valuation analysts often think second of cost approach valuation methods to value intellectual property. These valuation methods include the replacement-cost-less-depreciation method, the reproduction-cost-less-depreciation methods, and others.

Valuation analysts usually consider using income approach or cost approach valuation methods rather than market approach valuation methods. However, when properly applied, market approach valuation methods can produce a credible value conclusion. This article summarizes the factors to consider in deciding the applicability of the relief from royalty (RFR) method and the factors to consider in selecting a market-derived royalty rate.

THE RELIEF FROM ROYALTY METHOD

Valuation analysts commonly use the relief from royalty (RFR) method to estimate intellectual property value. They also use this valuation method to value other types of commercial intangible assets, as long as sufficient transactional data are available from which to extract a market-derived royalty rate. However, valuation analysts often find that there is a paucity of empirical data with regard to the arm's-length license of most commercial intangible assets. Because of this data constraint, valuation analysts use the RFR valuation method primarily to value patents, trademarks, copyrights, and trade secrets.

If adequate empirical data are available, the RFR method may be used to value commercial intangible assets that are related to intellectual property. Examples of such related commercial intangible assets include the following:

1. Unpatented but proprietary technology (related to patents)
2. Trade dress (related to trademarks)
3. Copyrighted computer software (related to copyrights)
4. Manuals and other documentation containing trade secrets (related to trade secrets)

The RFR method is based on the creation of a hypothetical arm's-length, third party license for the use of the subject intellectual property. In this intellectual property use license, the actual owner is the hypothetical licensee, and a hypothetical owner is the licensor. In this hypothetical transaction, the actual owner has to pay the hypothetical owner for the use of the subject intellectual property. In fact, the actual owner is assumed to pay the hypothetical owner a market-derived royalty payment for the use of the subject intellectual property. This market-derived royalty payment is based on the valuation analyst's analysis of empirical license agreements (between independent parties) for the use of comparable intellectual property.

Empirical intellectual property license agreement royalty payments are typically based on a contractually specified royalty rate. A contractually specified rate usually is calculated as one of the following:

1. X% of intellectual property operator revenue (or some other operator income measure)
2. $Y per intellectual property operator unit produced (or per operator unit sold)
3. $Z per time period (for example, per year)

Of course, in reality the current owner actually owns the subject intellectual property. Therefore, the current owner does not have to pay a third-party licensor to license the use of the subject intellectual property. Accordingly, as the actual intellectual property owner, the current owner is "relieved" from having to pay a royalty for the use of the subject intellectual property to a third party licensor.

It is noteworthy that the RFR method does not assume that the current owner outbound-licenses the subject intellectual property. That is, the RFR method does not apply the market-derived royalty rate to the other party's (the hypothetical licensor's) revenue. Rather, the RFR method assumes that the current owner inbound-licenses the subject intellectual property. That is, the RFR method applies the selected market-derived royalty rate to the actual owner/operator revenue.

RFR METHOD VALUATION FORMULA

The RFR method basic valuation formula is as follows:

$$\text{intellectual property value} = \frac{\text{owner/operator revenue} \times \text{royalty rate}}{\text{discount rate} - \text{growth rate}}$$

The RFR method basic valuation formula is appropriate only when the intellectual property revenue stream is a perpetuity and the annual rate of change in that intellectual property revenue stream (whether positive or negative) is expected to be constant. When these two simplifying assumptions are not appropriate, then the valuation analyst should modify the basic valuation formula accordingly.

That is, the direct capitalization procedure may not be appropriate if the subject intellectual property has a finite remaining useful life (RUL) or has an owner/operator revenue stream that is expected to change at an irregular rate. In such instances, the valuation analyst may have to use the yield capitalization procedure of the RFR method (instead of the simplified direct capitalization procedure presented above).

SELECTING THE MARKET-DERIVED ROYALTY RATES

The valuation analyst is ultimately responsible for selecting the market-derived royalty rate that is most appropriate to the subject intellectual property. To determine this subject-specific royalty rate, the valuation analyst typically selects an appropriate sample of guideline intellectual property license transactions. The sample should provide meaningful pricing guidance. The valuation analyst then adjusts the guideline intellectual property license royalty rates in order to make the guideline intellectual property licensees more comparable to the subject intellectual property. Finally, the valuation analyst selects the single royalty rate appropriate to the subject intellectual property. This selected royalty rate is based on the range indicated by the market-derived intellectual property royalty rates. The selected royalty rate is, in the valuation analyst's opinion, the most applicable to the subject intellectual property.

Exhibit 1 presents a list of some of the license rights and responsibilities that the valuation analyst may consider in the process of adjusting the guideline royalty rates and selecting the subject-specific royalty rate. The valuation analyst will typically compare these factors in the guideline intellectual property licenses with the same factors in the hypothetical subject intellectual property license.

Exhibit 1 is not intended to be a comprehensive list of all license rights and obligations. Of course, the valuation analyst should determine which factors are most appropriate to the subject intellectual property valuation.

FACTORS TO CONSIDER IN THE APPLICATION OF THE RFR METHOD

After considering the relative rights and responsibilities of the guideline intellectual property license agreement parties, the valuation analyst may consider noncontractual factors in the final selection of the subject-specific royalty rate. Exhibit 2 presents a list of some of the noncontractual factors. These noncontractual factors are primarily economic or functional (including technological) in nature, or both.

The valuation analyst may apply each of these factors in adjusting the guideline license royalty rates and selecting the ultimate subject-specific royalty rate. As with all comparative factors, the valuation analyst should compare (and adjust) the guideline intellectual property with the subject intellectual property—and not the subject intellectual property with the guideline intellectual property.

Exhibit 2 is not intended to be a comprehensive list. The valuation analyst should use his or her professional judgment and expertise to determine the comparable economic/functional factors that are most relevant to the subject intellectual property.

Exhibit 1. License Rights and Obligations Related to the Selection or Adjustment of Guideline Intellectual Property Royalty Rates

1. Specific products or services
2. Product or service line extensions
3. Specified geographic territories
4. Degree of exclusivity
5. Competition from licensor or licensee
6. Licensor/licensee required promotional expenditures
7. Licensor/licensee required research and development expenditures
8. Licensor/licensee required legal expenditures
9. Ability to sublicense
10. Ability to hypothecate
11. Ability to disaggregate the use rights
12. Term of the license
13. Extensions of license terms
14. Milestone payment commitments
15. New intellectual property rights of first refusal
16. Intellectual property expansion rights of first refusal
17. Intellectual property maintenance commitment
18. Intellectual property development commitment
19. National/international registration requirements
20. Termination rights and causes

In addition to the factors cited in exhibit 2, the valuation analyst should ultimately consider whether the RFR method is, in fact, appropriate to the subject intellectual property. Some of the factors to consider with regard to the use of the RFR method include the following:

1. Is the subject intellectual property the type of intellectual property that is regularly licensed?
2. Are there sufficient guideline intellectual property license transactional data to provide meaningful pricing evidence?
3. Do the guideline intellectual property licenses adequately capture the subject intellectual property-specific attributes?
4. Is the RFR method sufficiently appropriate to the engagement standard of value and premise of value?

SUMMARY

This discussion considered when and how to use the RFR method of intellectual property valuation. This discussion also summarized the factors that may affect whether the valuation analyst selects the RFR method in any particular valuation engagement. It also summarizes the factors that may affect the valuation analyst's final selection of market-derived guideline license royalty rates.

Exhibit 2. Comparative Factors to Consider in the Application of the RFR Method

Comparative factors between the subject intellectual property and the selected guideline intellectual property include the following:	*Absolute factors related to the subject intellectual property include the following:*
1. Seasoned intellectual property versus newly created intellectual property	1. Cost to maintain the subject intellectual property
2. Degree of competition and relative market share	2. Consumer (customer) perceptions
3. Barriers to entry	3. The licensee's operating plans
4. Subject industry/market growth rates	4. The licensor's particular experience
5. Subject industry/market profit margins	
6. Subject industry/market return on investments	
7. Expansion/commercialization opportunities	
8. Promotional, research and development, other expenditures	
9. Remaining useful life	
10. Place in the intellectual property life cycle	

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EXPERT TOOLS

A GUIDE TO THE BRAVE NEW WORLD OF FAIR VALUE

By Susan M. Saidens, CPA, ABV, CVA, CFE, ASA

A review of Valuation for Financial Reporting (Fair Value Measurements and Reporting, Intangible Assets, Goodwill, and Impairment, Second Edition, *by Michael J. Mard, James R. Hitchner, and Steven D. Hyden (Hoboken, NJ: Wiley)*

Valuation for Financial Reporting: Fair Value Measurements and Reporting, Intangible Assets, Goodwill, and Impairment, Second Edition is a book with practical guidance about fair value measurements and reporting, intangible assets, goodwill, and impairment issues for valuation specialists, auditors, and their clients in the private and public sectors.

The book is easy to read. It explains in laymen's terms the objectives of financial reporting and the recent Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*, from the perspective of the valuation specialist. This book provides a guide of how a fair value valuation report should be prepared and thus will also help an auditor better understand the fair value report and, consequently, better audit the valuation.

The scope of SFAS No. 157 is extensive to say the least. As is reported in the book, 67 existing Accounting Principles Board and FASB pronouncements refer to fair value at the date of this statement. Of those pronouncements, 28 are amended by SFAS No. 157. So, if you think that you don't need to know about fair value, think again.

Chapter one discusses the objective of fair value measurement and financial reporting. The chapter presents the new definition of fair value as required by SFAS No. 157 and explains the statement's hierarchy requirements. The first chapter also provides practical guidance for defining the following:

- Entry price versus exit price
- Principal (or most advantageous) market
- Transaction costs
- Market participants
- Highest and best use of an asset
- Inputs: observable and unobservable
- Active market

The second chapter discusses in depth SFAS No. 141, *Business Combinations* and SFAS No. 142, *Goodwill and Other Intangible Assets*, as well as SFAS No. 157, with emphasis on how to identify the distinguishing characteristics of goodwill and identifiable intangible assets, how to determine if impairment has occurred, and the significant changes in SFAS No. 141(R), which amends SFAS No. 141.

Two of the most critical changes brought about by the release of SFAS No. 141(R) are discussed in this chapter. The changes are the definition of a business combination and the definition of a business. This chapter also discusses best practices for the valuation of in-process research and development.

CASE STUDIES AND ILLUSTRATIONS

Chapter three provides detailed case studies in, and examples of, a purchase price allocation (illustrated with the valuation of seven separately identifiable intangible assets acquired in a business combination), as well as a case study of both steps one and two of a goodwill and other intangible assets impairment analysis.

COMPARING REPORTS AND REPORTING STANDARDS

Chapter four discusses the reports and reporting standards of the various valuation organizations in the United States, namely, the AICPA, the American Society of Appraisers (ASA), the Institute of Business Appraisers (IBA), the Appraisal Foundation (TAF), and the National Association of Certified Valuation Analysts (NACVA). The chapter presents a well-organized chart comparing the reporting standards promulgated by each of the agencies mentioned above. However, since the release of this book, the AICPA issued its final standards document, Statement on Standards for Valuation Services (SSVS) No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* (AICPA, *Professional Standards*, vol. 2, VS sec. 100), and NACVA has revised its *Professional Standards* to align better with SSVS No. 1 so that CPAs in those two organizations would not have conflicting standards.

CHECKLISTS

Chapter five includes several procedural checklists, including one for valuing intangible assets, an information request list to obtain documents and other information from the client, and a model audit program for in-process research and development for the auditor.

I would be remiss not to mention that those of us who are also Accredited Senior Appraisers will find a website address to view a USPAP-compliant PowerPoint presentation of a fair value report.

The brave new world of fair value provides a challenge for CFOs, auditors, valuation specialists and other CPAs in the private and public sectors. I highly recommend this book as a "must-have" guide through this brave new world.

Susan M. Saidens, CPA, ABV, CVA, CFE, ASA is managing director of SMS Valuation & Forensic Services, LLC, a niche business valuation and forensic accounting CPA practice. SMS Valuation & Forensic Services, LLC is a nationally known and recognized valuation firm operating out of a local office in Exton, PA. Susan can be reached by phone at 484-875-3068 or by email at sms@ValuationAndForensics.com.

REGISTER NOW FOR THIS YEAR'S ABV EXAM!!

Register now for the AICPA's 2008 Accredited in Business Valuation (ABV) exam! This year's exam window is scheduled from ***November 10 to December 13***. Registration is available from ***July 1 to October 31***. The exam registration fee is $550 for new registrants.

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In order to prepare for the upcoming exam, view the **Content Specification Outline** and take advantage of the courses we offer during the year: Participate in one of our intense three-day, state society hosted exam review courses. This year there will be five review courses hosted by the following state societies: California, Illinois, Florida, Maryland, and Texas. To find out more about the courses and registration, go online to http://fvs.aicpa.org/Events/ABV+Examination+Review+Courses.htm.

To learn more about the ABV exam and obtain an overview of the ABV credential, go online to http://fvs.aicpa.org/Memberships/Overview+of+the+Accredited+in+Business+Valuation+Credential.htm.

Have questions? Please email us at FVSinfo@aicpa.org.

THE CAPITAL STRUCTURE OF PRIVATELY HELD FIRMS

Borrowing costs predominate in the debt choices of small privately held firms. Tax calculations figure less in small firm capital structure decisions. These are findings of recent research from the Small Business Administration Office of Advocacy.

The capital structure decision—a fundamental issue faced by financial managers—is, simply put, how a firm finances its assets through some combination of debt and equity. Numerous studies have tested two theories of capital structure, focusing on publicly traded firms. A new Office of Advocacy study addresses the question of whether—and which—theories address the capital structure of small privately held firms. Rebel A. Cole authored the study, "What Do We Know About the Capital Structure of Privately Held Firms? Evidence from the Surveys of Small Business Finance." According to Cole, "This seemingly simple decision about the best mixture of capital sources to be employed in financing the firm's operation and growth has confounded researchers since the seminal 'capital structure irrelevance' theory of Modigliani and Miller (1958)."

Cole says further that existing empirical studies that test capital structure theories used data from large corporations which issue complex financial securities for both debt and equity. The question still unanswered, according to Cole is, "whether these theories are useful for understanding the capital structure of small privately held firms, which are primarily limited in their external borrowing to financial intermediaries such as banks, finance companies, and other business lending institutions."

The research offers new evidence of the degree of leverage or debt used by privately held companies and how it differs from that used by small publicly traded firms. It finds that small firm capital structure decisions are more likely to conform to the "pecking order" theory, which says that firms opt first for internally generated funds, then for debt, and, only as a last resort, for equity.

In contrast, the "trade-off" theory suggests that a firm's capital structure is related more to weighing the tax benefits of deductible interest against the costs of financial distress.

The Small Business Administration's "Research Summary" included the following highlights of the study:

- In aggregate, small privately held firms had similar leverage ratios when compared with small publicly traded firms, but not when compared by industry.
- Firm size affects leverage. Whether size is measured by total assets, annual sales, or employee totals, larger firms consistently use less leverage than smaller firms.
- Older firms use significantly less leverage than younger firms.
- Unprofitable firms consistently use greater leverage than profitable firms.
- More liquid firms use less leverage.
- No matter how risk is measured, riskier firms use more leverage.
- Firms that obtain financial services from a larger number of bank and nonbank financial institutions use more leverage.

The study used survey data collected by the Federal Reserve Board with funding from the Office of Advocacy. A summary of the research is available online at www.sba.gov/advo/research/rs324tot.pdf. The full text of the report is available online at www.sba.gov/advo/research.

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PREDICTING MATERIAL ACCOUNTING MANIPULATIONS

Why do managers manipulate financial statements? And how can financial analysts, investors, auditors, and regulators best detect their manipulations? Answers to these questions can help investors to improve their returns, auditors to more confidently detect manipulations and avoid costly litigation, and regulators to strengthen investor protection and prevent investment disasters. For financial analysts, the answers can help identify and curtail manipulation as well as protect their reputations.

To get answers to these questions, four academic researchers and an investment firm managing partner developed a comprehensive database of financial manipulations and analyzed the characteristics of the manipulating firms and the determinants of manipulations. The project was funded by the Research Advisory Board established by the Big Four accounting firms. The resulting analysis provided the basis for developing a model to predict manipulations and an associated Fraud Score (F-Score) that can assess the likelihood of manipulations.

THE DATABASE

The researchers' database included firms that were subjected to enforcement actions by the Securities and Exchange Commission (SEC) via *Accounting and Auditing Enforcement Releases* (AAERs). The researchers examined 2,191 AAERs issued from the inception of such releases in 1982 until 2005 and identified 680 firms that misstated at least one quarterly or annual financial statement.

MOST COMMON MANIPULATIONS

Most firms manipulated more than one income statement line item: most commonly, revenue (55% of sample firms); inventory and cost of goods sold (25%); and allowances, including allowances for doubtful debts (10%). Manipulations were most common in the following industries: computers and computer services, and retail and general services, such as telecommunications and healthcare. The researchers also found that 15.3% of the manipulations occurred in the largest 10% of firms, which they attributed to "the SEC's incentive to identify only the most material and visible manipulations involving large losses to numerous investors."

PERFORMANCE CHANGES

"A consistent theme," the researchers say, "is that the manipulating companies perform strongly before the manipulations. Therefore, managements' manipulations may be motivated by their hope to "disguise a moderating financial performance." In the years before the manipulations, the companies' stock returns outperform the broader market, "but underperform in the years following the manipulation." The companies experience decline in cash profit margins and earnings growth. However, accruals increase. Furthermore, demand for the companies' products drop as indicated by order backlogs and declines in employee headcount.

The researchers also found that during manipulation periods, leasing activity increased. They think that this increase "is consistent with managements' increased use of the flexibility granted by lease accounting rules to manipulate their firms' financial statements."

"Manipulations are intended to avoid disappointing investors' high expectations and to raise capital on favorable terms while expectations are still high," the researchers conclude. Consequently, manipulating companies "have abnormally high price-to-earnings and market-to-book ratios during manipulation years." Furthermore, during the manipulation years "issuances of debt and equity are both unusually high."

F-SCORE APPLICATIONS

The researchers developed a prediction model, the F-Score, to assess the probability that a firm has engaged in earnings manipulation. An F-Score greater than 1.0 indicates a high probability of manipulation.

The prediction model has three stages. The first stage includes variables that measure earnings quality and firm performance. These variables are obtained from primary financial statements. The researchers say that "the bulk of the predictive power of the models is obtained from . . . using financial statement variables."

The second and third stages provide "modest incremental improvements." The second stage adds off-balance sheet and nonfinancial measures, for example, leasing activity. The third stage adds market-related variables, for example, prior stock price performance and the book-to-market ratio.

The researchers and authors of the report include Patricia M. Dechow, The Haas School of Business, University of California, Berkeley; Weili Ge, University of Washington Business School, Seattle; Chad R. Larson, The Stephen Ross School of Business, University of Michigan, Ann Arbor; and Richard G. Sloan, Managing Director, Barclays Global Investors, San Francisco, CA.

A copy of the report is available for downloading online at **http://papers.ssrn.com/sol3/papers.cfm?abstract_id=997483**.

QUESTIONABLE MERGERS LINKED TO CEO ARROGANCE

Research by two University of Iowa business professors reinforces the adage that CEOs should not believe their own hype. Here's the report on the research issued by the University of Iowa News Service.

Research by two University of Iowa business professors provides the first evidence that CEOs may fall victim to their own perceived success when making merger and acquisition decisions. The research suggests that CEOs unwittingly give too much credit to their own ability when they initiate a successful acquisition. Their overconfidence encourages them to make more acquisitions that are apt to lose shareholder value.

However, Matt Billett and Yiming Qian, finance professors at the Henry B. Tippie College of Business, said their work also demonstrates that CEOs are unlikely to have sinister motives behind their value-destroying acquisitions, and that they frequently believe that they are acting in the best interests of their shareholders.

Billett's and Qian's research is contained in their paper, "Are Overconfident CEOs Born or Made? Evidence of Self-Attribution Bias from Frequent Acquirers." Their finding is that such CEOs are, in fact, made.

The two researchers examined mergers and acquisitions of publicly traded companies between 1980 and 2002, estimating the value of each by the stock market's reaction upon its announcement. They found that although a CEO's first acquisition leads to essentially no change in company value, subsequent mergers show a mean drop in value of 1.5 %.

What then determines the success of a merger? Billett and Qian suggest that simple chance is as likely a cause as anything. They said, "The research showed that post acquisition stock returns are mixed, with some performing better and some worse. This suggests post acquisition performance is probably due to chance."

What happens, however, is that some CEOs begin to think their skill had something to do with it.

THE HUBRIS HAZARD

"A CEO who is subject to self-attribution will tend to mistakenly credit expost success to his or her own ability," Billett and Qian write. "Success from prior acquisitions therefore leads to overconfidence and leads the CEO to more acquisitions. These subsequent acquisitions, however, will exhibit overconfidence and will be value destructive."

Insider trading data also demonstrate this hubris at work. Billett and Qian found that CEOs frequently purchase more of their own company's stock during the run-up to an acquisition. The researchers suggest that this demonstrates that the CEOs believe that their acquisitions will be successful because executives who know in advance that their acquisitions aren't likely to build value are also not likely to buy more shares of their own stock.

The researchers suggest in their paper that firms can counteract this hubris effect by more thoroughly examining acquisition proposals from CEOs who have been involved in multiple acquisitions in the past.

Billett's and Qian's paper was published in a June 2008 issue of the journal *Management Science* (**http://mansci.journal.informs.org/cgi/content/abstract/54/6/1037**).

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PRAISE FROM TOP PRACTITIONERS

Two leaders among valuation analysts offer the following praise for the new third edition:

- Mercer Capital CEO, Z. Christopher Mercer, ASA, CFA says, "Gary Trugman has done it again. The third edition of his *Understanding Business Valuation* provides a wide-ranging and practical introduction to the field. What I like best about the book is that Trugman tells the reader what he thinks. And he does so in typical Trugman style—his humor shows through in some of the thickest subject matter. And the book provides many practical examples and suggestions for a broad range of business valuation engagements. You'll be glad this book is in your library.
- James R. Hitchner, CPA/ABV, ASA, president of The Financial Valuation Group, editor-in-chief of the bimonthly *Financial Valuation and Litigation Expert*, and author and editor of books on valuation analysis, says, "Mr. Trugman's third edition of *Understanding Business Valuation* is packed with useful information written in his usual easygoing style. He presents difficult technical material in basic language that is actually fun to read. No easy task. However, that is one of Mr. Trugman's talents, and it comes shining through here. In addition, he includes many examples that guide both the novice and experienced valuation analyst through the process, from the engagement letter to the report. Very well done."

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